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Outlook for the Economy and Real Estate

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The Outlook for the Economy and Real Estate

The Commerce Department has revised upward the first quarter growth rate of real or inflation-adjusted Gross National Product (GNP) from 3.2 percent to 3.7 percent. However, the economy is not as robust as these figures suggest as all of this growth is attributable to an accumulation of inventories while final sales of goods and services actually declined. This underlying weakness of the economy is apparent in the economic indicators available thus far which suggest a second quarter real GNP growth rate of about 2 percent. During the second half of 1986 a modest rebound of economic growth is anticipated due to the stimulus to consumer spending and both residential and business investment provided by lower interest rates, lower oil prices, and the decline in the value of the dollar. During the third quarter growth of real GNP should rise to about 3-1/2 percent and should remain in the 3 to 3-1/2 percent range through the first quarter of 1987. For all of 1986 real GNP should increase about 2.5 percent compared to an increase of 2.2 percent in 1985 and 6.6 percent in 1984. During 1987 growth of consumer spending and residential investment should taper off but should be more than offset by more rapid growth of business investment and exports, boosting the overall growth rate to about 3 percent.

The second quarter growth rate of real GNP should be held down to about 2 percent due to a major inventory correction. Production in the current quarter is relatively weak as retailers, wholesalers, and manufacturers deplete the unwanted inventory buildup of the first quarter. New orders for durable goods fell in April for the third consecutive month. Industrial production was up modestly in April due entirely to an increase in automobile production in anticipation of increased sales due to strong financing incentives. Payroll employment increased a modest 149,000 in May compared to an increase of 313,000 in April. In May, payroll employment in goods-producing industries fell by 50,000 while the average workweek also declined, suggesting that industrial production may have actually declined in May. Overall, reduced inventory investment should subtract about 1-1/2 percentage points from the second quarter growth rate. On the other hand final sales should contribute about 3-1/2 percentage points to the second quarter growth rate as growth in consumption spending slows but remains positive, residential investment increases sharply, business investment rebounds from the sharp decline of the first quarter, and the trade balance continues to improve.

This second quarter should be a transition to a modest rebound of economic growth in the second half of 1986 prompted by the decline in interest rates over the past year, the sharp fall in energy prices, and the decline in the dollar relative to key currencies such as the Japanese yen and the West German mark. The decline in interest rates has already boosted housing construction which should provide strong stimulus to the economy over the remainder of this year. Lower rates should also encourage business investment which has otherwise been battered by sharp cutbacks in the domestic energy industry and an overall low capacity utilization rate. Further, the decline in interest rates has increased the value of bond holdings and helped push up stock prices, both of which increase household net worth and so encourage consumer spending. The decline in energy prices has been a major factor in the decline in interest rates and has also increased consumers' disposable income in a manner similar to a tax cut. Finally, the sharp and sustained decline of the dollar since the end of 1985 should put U.S. producers on a much more competitive footing which should translate into an improvement in the balance of trade. In April the merchandise trade deficit recorded a modest $2 billion improvement which should be followed by continued improvement in the months ahead.

It should be emphasized that this rebound is anticipated to be relatively modest in strength and duration and so should not lead to higher interest rates. Growth of real GNP should increase to about 3-1/2 percent in the third quarter and remain in the 3 to 3-1/2 percent range through the first quarter of 1987 before falling back under 3 percent. Three retarding forces are likely to put downward pressure on economic growth during this period:

1) restraint in government spending due to implementation of Gramm-Rudman-Hollings;

2) further cutbacks in domestic automobile production due to sluggish sales and high inventories; and

3) weakness in business investment in new equipment and structures.

The outlook for inflation continues to be dominated by the sharp decline in the price of imported oil that occurred earlier this year. Both the Consumer Price Index (CPI) and the Producer Price Index (PPI) have recorded monthly declines since February. For all of 1986 the CPI is anticipated to rise just 2 percent. However, as the effect of lower oil prices dissipates, underlying inflation in some sectors of the economy should reassert themselves. For example, prices of services, which account for half of consumer spending, have been increasing at an annual rate of about 4 percent due to wage pressures and modest productivity growth. The prices of imported goods and services have also been rising due to the decline of the dollar and should continue to rise at a rate much higher than the overall price level for the next several years. Therefore, inflation should start to increase in the second half of this year with the CPI increasing about 3 percent in 1987 and rising to about 3-1/2 percent in 1988.

The civilian unemployment rate rose to 7.3 percent in May from 7.1 percent in April as sluggish economic growth kept employment growth below the increase in the labor force. In May nonfarm payroll employment increased a modest 149,000, with employment in service-producing industries up by 199,000 and employment in goods producing industries down 50,000. Within the service sector, employment in finance, insurance, and real estate was up by about 350,000 over a year earlier reflecting the healthy state of the housing market. Similarly, employment in construction was up by about 310,000 jobs over a year earlier. Weakness in the manufacturing sector was evidenced by the fourth consecutive monthly decline in employment resulting in over 100,000 fewer jobs than a year ago. The overall unemployment rate should hover in the low seven percent range for at least the next 18 months as the modest rebound of the economy boosts employment just enough to keep the unemployment rate stable.

Monetary Policy and Interest Rates

The bond rally of the first part of the year has come to a halt as the bond market currently suffers from a case of indigestion with accompanying nervousness. After declining to low of 7.1 percent in April, the yield on 30-year U.S. Treasury bonds climbed back to 7.9 percent by the end of May. An increase in the index of leading economic indicators for April of 1.5 percent accentuated fears of a resurgence of economic growth which would preclude further easing by the FED and could cause rates to rise. Also contributing to investor jitters is the sharp decline in the value of the dollar relative to the yen which could curb the Japanese appetite for Treasury securities despite the continuance of a significant spread between U.S. and Japanese interest rates. Therefore, until a clearer picture of the state of the economy and the demand of foreign investors emerges, the tremendous bond rally of the past year is likely to remain on hold.

While future declines in interest rates are likely to be much more gradual than over the past year, further reductions in interest rates over the remainder of this year and into 1987 are expected. Mortgage interest rates should fall back to the 9-1/2 to 10 percent range by the end of 1986. The following underlying forces should contribute to this decline:

- o Low Inflation: Due to lower energy and food prices, inflation is expected to slow to 2.0 percent this year from a 3-1/2 percent rate in 1985. While inflation may accelerate modestly in 1987, it is expected to remain in the 3 to 4 percent range through 1988.

- o Sluggish Economic Growth: A second half growth spurt is anticipated but only to about 3 percent, not the 4 or 5 percent that some analysts have projected. The current economic expansion is in its fourth year and the consumer, the driving force of the recovery so far, is burdened with debt. If the recovery is to continue, lower interest rates are needed to spur residential and business investment.

- o Deficit Reduction: Both houses of Congress have already passed budgets which meet the FY 1987 Gramm-Rudman-Hollings deficit target of $144 billion. While the actual FY 1987 budget deficits will likely come in $10 to $20 billion higher than that, the fact that the deficit is declining is providing a psychological boost to the bond market plus contributing to sluggish economic growth. The lower deficit should also allow the FED to ease monetary policy with less fear of rekindling inflation.

Real Estate Markets

Housing has been the only sector of the economy exhibiting consistent strength in an environment of falling interest rates. The pace of total housing starts remains just under 2 million units and is expected to slow only slightly over the remainder of this year. The existing home market also remains robust as the annual pace of resales increased 11.3 percent from March to April to 3.56 million units--the highest level in 6-1/2 years. Existing home sales are expected to remain strong through 1986 averaging 3.5 million units for the entire year. By 1987, as mortgage interest rates near 9 percent, existing home sales should top 3.6 million units.

The rate of growth of resale activity differs across regions. According to April's existing home sales figures, the Midwest has posted the strongest gain over the past 12 months increasing 38 percent. The Northeast posted the next highest annual gain with a 27 percent increase. In the South resales were up 7 percent over a year ago while in the West they were up 2 percent.

As the demand for housing has strengthened, the rate of increase of home prices has accelerated. In April, the median resale price increased to $81,100--an increase of 8.4 percent over a year ago. For all of 1986 home prices are expected to well outpace inflation, increasing 6 percent over the entire year to a median price of $79,900.

The outlook for nonresidential construction remains mixed. Within commercial investment, construction of retail space should remain strong as increased housing activity spurs demand for nearby stores and warehouses. Office construction, on the other hand, should weaken as high vacancy rates and oversupply dampen investment in this area.

Table 1

June 1986

U.S. ECONOMIC OUTLOOK

	QUARTERS								YEARS				
	Actual		Forecast						Actual		Forecast		
	1985.4	1986.1	1986.2	1986.3	1986.4	1987.1	1987.2	1987.3	1984	1985	1986	1987	1988
AGGREGATE ECONOMY													
Gross National Product													
(billions of dollars)	4,059	4,121	4,164	4,228	4,285	4,346	4,400	4,456	3,775	3,989	4,200	4,430	4,676
% Change	4.3	6.3	4.3	6.2	5.5	5.8	5.0	5.2	11.0	5.7	5.3	5.5	5.6
% Change (w/out inflation)	0.7	3.7	1.9	3.4	3.2	3.0	2.8	2.5	6.6	2.2	2.5	2.9	2.5
Consumption	0.1	4.2	3.2	2.0	3.5	1.6	1.6	1.7	4.4	3.3	2.9	2.1	1.8
Durables	-13.3	0.2	4.6	-0.7	8.9	-1.5	0.7	1.6	12.4	8.4	1.8	2.0	2.3
Nondurables	0.6	6.9	1.9	3.5	2.3	1.9	1.4	1.5	3.4	2.3	3.1	2.0	1.7
Services	4.4	3.4	3.7	1.6	2.8	2.4	1.9	1.8	3.0	2.5	3.0	2.2	1.8
Residential Investment	5.7	-5.3	17.9	7.2	1.4	-2.5	-3.9	-3.2	13.2	1.7	8.1	0.2	-1.9
Nonresidential Investment	11.3	-13.0	5.2	5.3	6.4	4.2	3.2	3.8	19.5	9.7	1.5	4.4	3.3
Structures	7.2	-11.3	0.2	2.0	4.0	4.1	4.5	4.1	14.7	11.4	-0.7	3.6	3.4
Equipment	13.5	-13.9	8.0	7.0	7.3	4.3	2.5	3.6	22.2	8.8	2.7	4.8	3.2
Exports	6.6	10.6	4.8	6.1	6.9	7.7	7.9	8.1	6.2	-3.0	4.5	7.3	7.2
Imports	24.5	-1.1	1.8	0.4	1.4	1.0	1.0	-0.9	22.8	2.7	6.3	0.4	-0.6
Government Purchases	9.2	-13.6	-3.6	0.0	0.4	1.2	1.0	0.9	4.3	6.0	-0.3	0.5	0.7
Contribution to GNP Growth													
Consumption	0.1	2.7	2.1	1.3	2.2	1.0	1.0	1.1	2.2	1.9	2.1	1.1	1.2
Residential Investment	0.3	-0.3	0.8	0.4	0.1	-0.1	-0.2	-0.2	0.2	0.3	0.4	-0.2	0.0
Nonresidential Investment	1.4	1.8	0.7	0.7	0.8	0.6	0.4	0.5	1.9	0.8	0.1	0.5	0.4
Structures	0.3	-0.6	0.0	0.1	0.2	0.2	0.2	0.2	0.6	0.4	-0.1	0.2	0.1
Equipment	1.1	1.5	0.7	0.6	0.6	0.4	0.2	0.3	1.3	0.5	0.1	0.3	0.3
Inventory Change ($ billions)	-0.5	4.5	-1.5	0.5	-0.5	0.7	0.7	0.0	0.4	-1.2	0.7	0.4	-0.1
Net Exports	-2.3	1.2	0.7	0.5	0.5	0.6	0.7	1.0	-1.5	-1.2	0.7	0.8	0.7
Government Purchases	1.8	-2.9	-0.7	0.0	0.1	0.2	0.2	0.2	1.5	1.5	-0.9	0.2	0.1
Mfg. Capacity Utilization Rate	80.1	80.0	79.1	79.5	79.8	80.1	80.3	80.4	80.8	80.3	79.6	80.4	80.9
Domestic Auto Sales	7.0	7.9	7.9	7.5	7.7	7.7	7.4	7.2	8.0	8.3	7.8	7.4	6.8
Personal Income Per Household	40,616	41,065	41,355	41,705	42,073	42,493	42,885	43,259	38,175	40,029	41,543	43,078	44,787
Percent Change -- Year Ago	4.3	3.9	3.6	4.1	3.6	3.5	3.7	3.8	10.4	4.9	3.8	3.7	4.0
Personal Taxes Per Household	6,156	6,090	6,157	6,237	6,318	6,293	6,363	6,428	5,420	5,987	6,200	6,412	6,665
Percent Change -- Year Ago	8.9	-0.5	9.5	3.1	2.6	3.4	3.3	3.1	12.2	10.5	3.5	3.4	4.0
Percent of Personal Income	15.2	14.8	14.9	15.0	15.0	14.8	14.8	14.9	14.2	15.0	14.9	14.9	14.9
Disposable Personal Income Per Household	34,460	34,975	35,198	35,469	35,755	36,200	36,522	36,831	32,755	34,042	35,343	36,666	38,122
Percent Change -- Year Ago	3.5	4.7	2.7	4.3	3.7	3.5	3.7	3.9	8.3	3.9	3.8	3.7	4.0
Employment (millions)	108.0	108.8	109.1	109.4	109.8	110.0	110.2	110.6	105.0	107.2	109.3	110.4	112.0
(civilian household basis)													
% Change	3.0	2.9	1.2	1.2	1.3	0.7	1.0	1.2	4.1	2.1	1.9	1.1	1.4
Unemployment Rate (%) (civilian)	7.0	7.1	7.0	7.1	7.0	7.1	7.2	7.2	7.5	7.2	7.0	7.1	6.8
Consumer Prices (CPI)	4.4	1.4	1.7	3.2	2.9	5.0	3.4	3.5	4.3	3.5	2.0	2.9	3.5
GNP Deflator	3.3	2.5	2.4	2.8	2.3	2.7	2.1	2.6	4.1	3.3	2.7	2.5	3.0
Personal Cons. Inflation	4.4	1.1	1.5	2.5	2.4	2.9	3.0	3.1	4.1	3.2	2.3	2.7	3.1
Residential Construction Inflation	5.7	5.6	3.1	3.4	3.1	2.8	2.9	3.2	4.2	1.9	3.8	3.1	3.8
Nonresidential Construction Inflation	0.8	4.0	3.5	3.8	3.0	3.2	3.3	3.6	0.5	1.4	2.7	3.4	4.1
Producer Price Inflation	4.7	-5.7	-0.1	0.5	2.3	3.5	3.5	3.9	2.1	0.9	-0.4	2.8	4.2
Before Tax Corporate Profit	234	218	231	242	253	259	258	262	238	225	236	261	282
Corporate Tax Liability	87.1	78.5	86.1	92.4	97.6	100.2	99.4	100.9	93.6	85.1	89.1	100.9	109
After Tax Profits	147	140	143	149	156	159	159	161	144	140	147	161	173
Inventory Valuation Adjustment	-10.1	17.3	1.2	-0.9	-10.3	-13.2	-14.0	-16.8	-5.4	-0.6	1.3	-15.8	-20.3
Capital Consumption Allowance	79	79	84	88	93	98	102	107	41	71	86	105	106
Federal Tax Receipts (NIPA)	803.5	802.9	813.9	828.8	840.8	848.2	855.9	865.4	725.1	784.7	821.6	862.3	908.8
% of GNP	19.8	19.5	19.5	19.6	19.6	19.5	19.5	19.4	19.2	19.7	19.6	19.5	19.4
Federal Expenditures (NIPA)	1030.4	1013.4	999.8	1001.8	1009.1	1018.9	1028.7	1039.4	898	984.7	1006	1033.9	1075.3
% of GNP	25.4	24.6	24.0	23.7	23.5	23.4	23.4	23.3	23.8	24.7	24.0	23.3	23.0
Deficit(NIPA)	-226.9	-210.5	-185.9	-173.0	-168.3	-170.6	-172.9	-174.0	-172.9	-200.0	-184.4	-171.1	-166.5
% of GNP	5.6	5.1	4.5	4.1	3.9	3.9	3.9	3.9	4.6	5.0	4.4	3.9	3.6
% of Net Domestic Savings	74.4	62.1	58.4	54.0	53.4	51.3	51.6	51.7	51.1	63.5	57.0	51.1	47.9

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy
Assumptions and simulations by Dr. Richard Peach, Janemarie Mulvey, and Sean Burns.

TABLE 3

June 1986

REAL ESTATE AND FINANCIAL MARKETS

	QUARTERS							YEARS				
	Actual		Forecast					Actual		Forecast		
	1985.4	1986.1	1986.2	1986.3	1986.4	1987.1	1987.2	1987.3	1984	1985	1986	1987	1988
REAL ESTATE MARKETS													
Total Single-Family Home Sales (single-family resales and completions)	4,542	4,467	4,702	4,780	4,870	4,848	4,812	4,730	3,933	4,255	4,705	4,758	4,529
Percent Change -- Year Ago	18.6	11.0	15.2	9.2	7.2	8.5	2.3	-1.0	5.1	8.2	10.5	1.1	-4.8
Existing Single-Family Sales (1000's)	3,500	3,257	3,495	3,579	3,669	3,675	3,645	3,583	2,866	3,214	3,500	3,601	3,400
Percent Change -- Year Ago	24.4	10.1	14.8	6.5	4.8	12.8	4.3	0.1	5.7	12.1	8.9	2.9	-5.6
Dollar Volume (billions)	318.9	307.3	367.3	384.4	381.9	402.8	417.2	419.5	247.1	291.4	360.2	409.1	416.5
Existing Home Prices - Median ($1000's)	75.2	76.1	80.2	81.3	79.8	82.3	84.6	85.8	72.4	75.5	79.9	84.2	88.4
Percent Change Year - Ago	4.5	5.8	6.2	6.1	6.0	5.4	5.5	5.6	3.0	4.3	6.0	5.5	5.0
Monthly Mortgage Payment (P&I, 80%, 30 yr.)	564.5	542.6	528.7	525.5	507.1	520.8	524.0	525.9	618.0	609.0	526.0	519.3	515.2
Percent of Median Family Income	26.1	24.8	24.0	23.6	22.6	23.0	22.9	22.8	26.2	26.2	23.7	22.6	21.6
Housing Starts (1000's)	1,773	1,988	1,985	1,975	1,970	1,903	1,860	1,862	1,703	1,741	1,980	1,871	1,807
Percent Change -- Year Ago	10.0	12.9	13.9	17.0	11.1	-4.3	-5.3	-5.7	3.4	-1.2	13.7	-5.5	-3.4
Single-Family Units (1000's)	1,074	1,248	1,244	1,238	1,236	1,210	1,203	1,182	1,100	1,073	1,242	1,193	1,163
Percent Change -- Year Ago	2.5	13.6	16.4	18.1	15.2	-3.1	-3.3	-4.5	3.3	-2.5	15.8	-4.0	-2.4
Multi-Family Units	699	740	741	737	732	693	677	680	603	669	738	679	644
2-4 Family Units (1000's)	80	101	101	101	100	95	93	93	122	93	101	93	88
Percent Change -- Year Ago	-30.7	0.0	-0.6	12.9	25.8	-6.4	-8.6	-7.8	7.0	-23.4	8.5	-8.0	-5.2
5+ Family Units (1000's)	619.7	639	638.5	636.1	631.8	598.3	584.2	586.5	541.9	575.8	636.6	585.8	555.6
Percent Change -- Year Ago	37.6	53.8	11.8	15.7	2.0	-6.4	-8.6	-7.8	2.8	6.2	10.6	-8.0	-5.2
Mobile Homes Shipped (1000's)	288	262	264	266	268	266	268	267	295	283	265	267	271
New Single-Family Home Sales (1000's)	696	789	720	756	764	751	730	705	636.8	688.5	757.8	716.8	689.8
Percent Change -- Year Ago	12.8	18.3	3.9	6.6	9.8	-4.8	1.4	-7.8	1.7	8.4	10.1	-5.3	-3.8
New Home Prices - Median ($1000's)	86.8	88.0	89.9	91.7	93.2	93.3	93.6	93.8	80.0	84.1	90.7	93.7	97.6
Percent Change -- Year Ago	8.1	6.2	7.0	10.7	7.4	6.0	4.1	2.3	6.1	5.2	7.8	3.3	4.2
New Home Prices - Mean ($1000's Quality Adj.)	106.4	104.6	108.1	109.1	110.1	107.9	111.3	112.4	96.8	104.0	108.0	111.3	115.5
Percent Change -- Year Ago	7.5	3.4	3.8	4.6	3.5	3.1	3.0	3.0	6.6	7.4	3.8	3.0	3.8
NAR Affordability Index	99.3	100.6	104.0	105.5	110.3	108.5	104.8	109.4	84.6	90.3	105.1	109.3	113.6
Mortgage Debt Outstanding ($ billions)	2,280	2,309	2,490	2,473	2,547	2,618	2,687	2,757	1,948	2,163	2,433	2,722	3,006
Housing Inventory (millions)	95.8	96.3	96.8	97.3	97.8	98.3	98.8	99.2	93.4	95.2	97.0	99.0	100.9
Rental Vacancy Rate (%)	6.7	6.9	6.8	6.7	6.7	6.6	6.6	6.5	5.8	6.5	6.8	6.6	6.4
Office Vacancy Rate (%) <1>	16.5	16.6	16.8	16.8	16.9	17.0	16.8	16.7	13.9	16.0	16.8	16.8	16.4
Industrial Vacancy Rate (%) <1>	4.9	4.9	4.8	4.6	4.5	4.3	4.3	4.2	4.7	4.7	4.7	4.3	4.0
FINANCIAL MARKETS													
Money Supply (M1)(% change)	11.1	7.9	12.2	7.5	5.7	5.3	4.6	5.4	7.0	9.1	10.2	5.9	5.0
Velocity of M1 (% change)	-6.1	-1.5	-7.0	-1.2	-0.2	0.5	0.4	-0.2	3.7	-3.1	-4.5	-0.5	0.5
Value of the U.S. Dollar (Trade-Weighted)	128.2	119.5	114.0	112.8	111.7	110.6	109.4	108.0	138.3	143.2	114.5	108.7	106.7
Percent Change	28.1	24.5	-17.1	-4.0	-4.0	-4.0	-4.0	-5.0	10.4	3.5	-20.1	-5.1	-1.8
Flow of Funds (NIA Basis) (Billions of dollars, saar)													
Sources (Total Gross Savings)													
Private Saving	694	726	718	732	732	756	770	781	693	694	727	775	827
Personal Saving	115	126	120	119	110	124	125	125	173	129	119	123	131
Savings Rate	4.0	4.4	4.1	4.0	3.7	4.1	4.1	4.0	6.5	4.6	4.1	4.0	4.1
Gross Business Savings	579	600	598	613	622	634	645	657	521	565	608	651	695
Federal Deficit	-227	-211	-186	-173	-168	-171	-173	-174	-173	-200	-184	-171	-167
State & Local	59	65	59	56	58	56	58	58	64	59	59	58	59
Net Foreign Investment	153	134	136	130	125	122	123	125	91	115	131	123	113
Uses (Total Gross Investment)	661	715	719	739	748	768	778	787	674	669	730	783	829
Nonresidential Investment	487	470	476	482	489	494	498	503	430	472	479	500	517
Structures	169	164	164	165	166	168	170	172	149	166	165	171	176
Equipment	318	306	312	317	323	326	328	331	282	306	315	330	340
Residential Investment	176	178	185	189	189	188	186	185	198	171	185	186	182
Inventory Investment ($ billions)	-6	33	18	23	16	24	31	30	63	6	23	30	32
Selected Interest Rates (%)													
Mortgage Rates													
30-year Fixed Rate Mortgage<2>	11.3	10.4	9.9	9.7	9.6	9.5	9.3	9.2	13.8	12.2	9.9	9.3	8.8
Real Mortgage Rate	8.0	7.9	7.5	6.9	7.3	6.8	7.2	6.6	9.7	8.9	7.2	6.8	5.8
1-year ARM (without buydown)	9.5	9.1	8.1	7.9	8.3	8.1	8.1	7.9	12.5	10.0	8.3	8.0	7.7
Real Mortgage Rate	6.2	6.6	5.7	5.1	6.0	5.4	6.0	5.3	8.4	6.7	5.6	5.3	4.7
Corporate AAA Bond Rate	10.9	9.6	8.9	8.5	8.3	8.2	8.1	7.9	12.7	11.4	8.8	8.0	7.5
Government Bond Rate	10.2	8.9	7.9	7.5	7.3	7.4	7.3	7.2	12.5	11.0	7.9	7.2	6.6
Real Government Bond Rate	6.9	6.4	5.5	4.7	5.0	4.7	5.2	4.6	8.4	7.7	5.2	4.7	3.8
Federal Funds Rate	8.1	7.8	6.8	6.5	6.7	6.5	6.4	6.2	10.2	8.1	7.0	6.3	6.2
3-Month T-Bill Rate	7.2	7.0	6.1	5.8	6.1	5.9	5.9	5.6	9.5	7.5	6.2	5.7	5.6
Real 3-month T-Bill Rate	3.9	4.5	3.7	3.0	3.8	3.2	3.8	3.0	5.4	4.2	3.5	3.2	2.6
1-Year T-Bill Rate	7.9	7.5	6.5	6.3	6.7	6.5	6.5	6.3	10.9	8.4	6.7	6.4	6.1
Real 1-Year T-Bill Rate	4.6	5.0	4.1	3.5	4.4	3.8	4.4	3.7	6.8	5.1	4.0	3.9	3.1
Prime Rate	9.5	9.4	8.6	8.3	8.3	8.3	8.4	8.1	12.0	9.9	8.6	8.1	7.6
Discount Rate	7.5	7.4	6.6	6.3	6.1	6.2	6.1	6.0	8.8	7.7	6.6	6.0	5.8

<1> Historical Data courtesy of Coldwell Banker
<2> FHA Secondary Mortgage Market Rate

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. Richard Peach, Janemarie Mulvey, and Sean Burns.

Special Supplement

Macroeconomic Impacts of the Senate Finance Committee Proposal

The so-called tax reform proposal unanimously approved by the Senate Finance Committee (SFC) on May 7 is likely to reduce the long-run growth potential of the U.S. economy and to pose considerable risk of a recession in the short-run should it be enacted into law. Conceptually, the basic thrust of the SFC proposal is to cut personal and corporate tax rates while expanding the tax base by limiting or repealing many personal and business deductions so as to raise roughly the same amount of tax revenue as current law (i.e., revenue neutrality). However, while aggregate federal revenues are projected to remain roughly constant, personal tax revenues are expected to decline by roughly $100 billion over five years. This cut in personal taxes is financed through an increase in tax burden on income earned from capital assets, particularly real estate. The reduction in personal taxes would encourage greater consumption spending while the increase in taxes on capital assets would create disincentives for capital formation relative to current law, thereby discouraging investment. Over time, the composition of Gross National Product (GNP) would shift toward consumption and away from investment, resulting in a significant loss in the economy's long-run growth potential.

The decline in personal taxes and resulting increase in consumption spending is likely to provide stimulus to the economy. However, this stimulus should be somewhat muted due to particular features of this proposal. In 1987 the tax base would be broadened effective January 1 while marginal tax rates would not be reduced until July 1. Consequently, personal disposable income would decline in 1987, the fifth year of the current economic expansion. Secondly, the loss of personal interest deductibility will raise the after-tax financing cost for consumer durables such as automobiles, furniture, and major appliances which should somewhat offset the effect of increased disposable income.

While stimulating consumption spending, the SFC proposal would discourage capital formation in new equipment, commercial and industrial structures, and both rental and owner-occupied housing. The proposal will increase the rental price of investment through repeal of the investment tax credit, lengthening of depreciation periods for structures, repeal of the capital gains exclusion, and loss limitation provisions. The after-tax cost of owner-occupied homes would rise in response to a devaluation of the traditional homeownership itemized deductions due to lower marginal tax rates and the increase in the standard deduction.

Table 3 presents the results of a macroeconomic simulation of the SFC proposal using the Washington University Macro Model. On balance, the overall rate of economic growth is depressed significantly by the proposal, with the level of real GNP reduced by two percent in the second year after enactment and remaining that much lower through the end of the forecast interval. Clearly, the disincentives to capital formation overwhelm the stimulative effects of increased consumption spending, even in the short-run. Within three years of enactment the level of investment in new equipment is reduced by about 13 percent while investment in new nonresidential structures is about 7 percent lower. Initially, total housing starts decline by about 330 thousand units or 17 percent. This decline in starts is made up of a 10 percent decline in single-family units, most of which are owner-occupied, and a nearly 30 percent decline in multi-family starts, most of which are renter-occupied. Sales of existing single-family homes initially decline by over 300,000 units or about 9 percent due to the increase in after-tax

homeownership costs. Note that the adverse impact on housing starts and resales subsides over time as mortgage rates decline due to a weakening economy, increases in rents resulting from the initial decline in starts, and a general decline in the value of existing properties. However, this decline in property values reduces household net worth and so acts to dampen consumption spending.

The lower level of economic growth results in slower growth of employment and a higher unemployment rate. Within five years total employment is lower by nearly two million jobs while the unemployment rate is increased by nearly two percentage points. Also, while the SFC proposal may be revenue neutral in a static sense, it is not dynamically revenue neutral in that the lower level of economic growth causes the federal deficit to increase by roughly $30 billion.

Table 3

Macroeconomic Impacts of the Senate Finance Committee Tax Proposal[1/]
(percent change from baseline)
unless otherwise noted

	1986	1987	1988	1989	1990	1991
Real GNP	-0.1	-1.5	-2.0	-2.1	-2.1	-2.0
Inflation (Percentage Points)	0.0	-0.2	-0.4	-0.4	-0.3	-0.3
Employment (Millions of Jobs)	0.0	-0.6	-0.9	-1.3	-1.7	-1.9
Unemployment Rate (Percentage Points)	0.1	0.5	1.1	1.4	1.7	1.9
Mortgage Rate (Percentage Points)	0.0	-0.2	-0.4	-0.7	-1.1	-1.3
Housing Starts (Thousands of Units)	0.0	-330	-226	-143	-92	-75
Percent Change	0.0	-17.1	-12.1	-7.6	-4.9	-4.0
Single Family	0.0	-128	-79	-51	-31	-25
Percent Change	0.0	-10.4	-6.5	-4.2	-2.5	-2.1
Multi-Family	0.0	-203	-149	-92	-63	-50
Percent Change	0.0	-29.3	-22.6	-14.0	-9.5	-7.7
Existing Home Sales (Thousands of Units)	0.0	-316	-202	-131	-81	-68
Percent Change	0.0	-8.9	-5.6	-3.6	-2.2	-1.8
Nonresidential Investment						
Equipment	-1.2	-6.4	-10.9	-13.0	-13.7	-13.1
Structures	-0.3	-3.1	-5.9	-6.8	-6.7	-6.8
Federal Deficit (Billions of Dollars)	-1.9	-0.8	28.2	30.1	33.1	33.7

1/Assumes no changes in monetary policy from the baseline.

Source: NATIONAL ASSOCIATION OF REALTORS®; simulation produced using the Washington University Macro Model.